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SUBJECT: SPAIN UNVEILS BUOYANT 2006 BUDGET

REF: MADRID 3460

11. (U) SUMMARY: Second Vice President and Minister of Economy Pedro Solbes Mira presented the Socialist government's general state budget to Congress on September 27. The budget prioritizes increasing productivity and reducing public debt. The five pillars of the budget are research, development, and innovation (R&D&i), infrastructure, education, Official Development Assistance, and public services. Solbes forecast a budget surplus of 0.2% of GDP, and a 7.3% increase in government spending. The budget assumes growth of 3.3% and inflation of 2%. The budget takes risks by assuming that interest rates will hold at 2% and that the average crude oil barrel price will be 55 USD. END SUMMARY.

Introduction

12. (U) Second Vice President and Minister of Economy Pedro Solbes Mira presented the Socialist government's draft budget to Congress on September 27. The stated goals of the overall budget are to reduce public debt and to increase productivity, goals not unlike those of the 2005 budget. Solbes also announced a five pillar strategy for prioritization of spending. While other EU member states struggle with budget deficits, Solbes forecast a small budget surplus of .2% of GDP for 2006. The small surplus is possible due to a 9.8% increase in direct tax revenues and social security contributions. The increase in contributions is due, in part, to an immigration amnesty program for more than 600,000 illegal immigrants that has brought a large part of the underground economy out into the open. As a result, government revenues are forecast to be up 8.4%. Government spending is slated to increase 7.7%.

Approval Process

13. (U) Spanish law requires approval of the budget from both houses of Congress prior to implementation. Solbes' budget must be debated within the Chamber of Deputies, a process during which amendments can be made. Following this, the budget will be sent to the Senate for its own debate and approval process. The Senate will then send the budget back to the Chamber of Deputies for final approval. If the budget proceeds through both houses of Congress according to the government's schedule, it should receive final approval during the last week of December. Spending limits outlined in the 2005 budget will be carried over into 2006 if the budget is not approved by the end of the year.

Winners

14. (U) Solbes' 2006 budget has a basic five pillar strategy. The first is improved productivity through greater investment in research, development, and innovation (R&D&i). Funding destined for R&D&i is to be increased by 29.7% for a total investment of 6.5 billion euro. In reality, only 4.8 billion euro of this amount will go to civil R&D&i, with the rest allocated to defense research, contributing to criticism about the GOS' commitment to support an increase in R&D&i. Total spending will still account for only slightly over 1% of GDP, far from its goal of 2% by 2010.

15. (U) The second pillar calls for an increased investment in infrastructure in order to further improve productivity. Plans are to increase spending 12.4% over 2005, for a total of 12.8 billion. The increase in the infrastructure allocation will partially compensate for the loss of EU structural funds that contributed to the construction of Spain's modern road network.

16. (U) The third pillar, education, will receive a 16.6% increase, the majority of which will be allocated to secondary education. Prime Minister Zapatero had promised that education would be the "star" of the 2006 budget. The debate continues as to whether or not the proposed increase will be sufficient to address the concerns of the current

education administration.

17. (U) The fourth pillar is an improvement in the quality of public services, which will receive a 9.9% increase in 2006. The main priority within this pillar is a reorganization and modernization of the Justice department, which will receive 12% more over 2005. Salaries in the armed forces and judiciary will also be raised 8% next year, supporting the government's hopes to increase armed forces recruitment levels.

18. (U) An increase in Official Development Assistance (ODA) is the final pillar. Direct ODA spending is proposed to dramatically increase by 57.1% to a total of 681.46 million euro. Total ODA spending would account for .35% of GDP. See reftel for more detailed information on the proposed ODA increase

Losers -----

19. (U) Most programs previously funded will not experience a decrease in net spending in 2006. However, a number of organizations and public entities will lose funding, including: the Spanish Patent and Trademark Office (-18.8%); the Gerencia de Infraestructuras y Equipamiento de Defensa, the government agency that manages the railways and defense equipment, (-15.6%); the Nuclear Security Council (-5%); the National Statistics Institute (-2.0%); and other miscellaneous state foundations (-15.11%). Miscellaneous economic programs will also lose 12.1%. Two autonomous regions will also lose funding in 2006, the Balears (-10.12%) and the Basque Country (-3.66%). On an interesting note, in spite of Solbes' proclaimed goal of reducing public debt, funding to pay off the debt is reduced in the 2006 budget by 9.6% from 2005.

Assumptions in the Budget Process -----

10. (U) The budget is based on 2% inflation and a predicted 3.3% economic growth rate for 2006, a rate that remains much higher than the EU average. A somewhat more risky assumption in the budget is that interest rates will remain at 2%, which is unlikely given recent statements by the European Central Bank. Further, the budget assumes an average crude oil barrel price of 55 USD, well below the current market rate. In fact, soaring oil prices led to a near doubling of Spain's current account deficit in 2005 to 33 billion euro or 7.5% of GDP.

Political Context -----

11. (SBU) Solbes has been vocal in stating that this year's budget is the first true reflection of the PSOE socialist government's priorities, claiming that the 2005 budget was influenced by decisions made by the previous conservative PP government. The socialists are likely to gain from a decision to hold both corporate and personal income taxes steady, with the caveat that ceilings on brackets will be raised by 2% to allow for inflation.

12. (SBU) Catalonia will be one of the main beneficiaries of spending on infrastructure. The perception that the PSOE government is placating the Catalan regional government in order to avoid further political separatism may create resentment amongst the other regions. However, the socialists are a minority government and must rely on the support of smaller parties such as the left-wing Catalan ERC party in Congress in order to guarantee approval of the draft budget. Nonetheless, the Catalan regional government maintains that is being shortchanged in per capita spending when compared with the autonomous community of Madrid.

Economic Context -----

13. (U) Spain is in its 10th year of uninterrupted economic growth boosted by improved fiscal management. Low interest rates accompanied the arrival of the euro which has also fueled cheap credit and a housing and construction boom. Property prices have risen by more than 150% since 1997. Fears linger that the overpriced housing market, coupled with the growing debt burden of Spanish families, may lead to a decline in economic growth. Spain is also losing its competitive edge, as unskilled manufacturing jobs migrate to Eastern Europe and Asia, and tourism faces the increasing popularity of cheaper foreign destinations.

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